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In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 501

THE OKONITE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 160a–178a) is reported in 4 T. C. 618. The opinion of the circuit court of appeals (R. 181–189) is reported in 155 F. 2d 248.

JURISDICTION

The judgment of the circuit court of appeals was entered on April 18, 1946 (R. 190). By order of the Chief Justice, dated July 17, 1946, the time for filing a petition for a writ of certiorari was extended to September 15, 1946 (R. 191). The petition for a writ of certiorari was filed on Sep-

tember 14, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the record warrants the conclusion by the Tax Court that the distribution to its stockholders by taxpayer corporation of its 6% preferred stock in exchange for its 7% preferred stock constituted, as the Commissioner contends, an integrated transaction of reorganization by recapitalization within the meaning of Section 112 of the Revenue Act of 1936, with respect to which taxpayer may not have a dividends paid credit, and not, as taxpayer contends, a severable transaction including as one of its steps payment of a taxable stock dividend, on the basis of which taxpayer might be entitled to a dividends paid credit.

STATUTES INVOLVED

The pertinent provisions of the Revenue Act of 1936 are set forth in the Appendix, *infra*, pp. 12–15.

STATEMENT

This controversy involves deficiencies in income tax for 1936 and 1937, and in excess profits tax for 1937 (R. 178a–179a). The Tax Court made findings of fact, as follows:

Taxpayer is a New Jersey corporation, engaged since 1878 in the manufacture and sale of insu-

lated wires and cables (R. 162a). In 1927, in order to raise sufficient money to purchase a similar business of another company and for other purposes, taxpayer issued and sold $2,000,000 face amount, fifteen year, 5½% sinking fund debentures, and $1,000,000 par value 7% cumulative preferred stock (R. 163a). The bonds carried minimum sinking fund provisions of $70,000 annually (R. 163a), and the preferred stock of $40,000 annually (R. 166a).

In 1934, taxpayer was feeling the effects of the depression. It had operated at a loss for each of the three preceding years, and, because of the sinking fund requirements, it was being drained of cash and its credit with the banks was becoming impaired (R. 164a). To alleviate this condition, a plan was proposed to release the sinking fund provisions for the bonds, acceptance of which was optional with the holders (R. 164a–165a). On assenting bonds, the interest rate was increased from 5½% to 6% (R. 165a). In 1934, 77.2% of the bonds were deposited to evidence acceptance, enough to render the plan operative. For those who did not assent, the terms of the old agreement remained in effect. (R. 165a.) With respect to these 5½% bonds, while there was no deficiency at the end of 1937, there remained a deficiency of $14,000 in the sinking fund at the end of 1936 (R. 166a).

Prior to 1936, taxpayer's 7% preferred stock, issued as already stated in 1927, and consisting

of 10,000 shares of $100 par value, was entitled to 7% cumulative dividends before any dividends could be paid on taxpayer's outstanding 50,000 shares of common stock. The preferred stock was callable at $115 per share. (R. 166a.) Dividends were paid regularly by taxpayer upon both the preferred and common stock through October 1931, but from January 1932, continuously through December 10, 1936, the common stock dividends were passed. Moreover, dividends on the preferred stock was passed from May 1932, continuously through August 17, 1936.[1] (R. 166a–167a.)

Thus, in 1936, dividends on the preferred stock were in arrears in the amount of $31.50 per share. In addition, taxpayer was also in arrears with respect to the sinking fund requirements on the preferred stock, and was short of cash. Consequently, a plan was devised whereby the sinking fund provisions would be made less stringent and the arrears in dividends eliminated. (R. 167a, 174a.)

This plan, drafted September 24, 1936, was entitled (R. 168a):

> Plan and Agreement for Recapitalization, Exchange of 7% preferred stock for 6% preferred stock and Payment of Dividends in Arrears on 7% Preferred stock.

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[1] If four quarterly dividends were passed without payment on the preferred, the latter obtained share for share voting rights with the common, as was actually the situation from April 18, 1933, to April 20, 1937 (R. 121a–122a, 182).

On the day previous, taxpayer's certificate of incorporation had been amended to authorize a new class of 11,000 shares of $100 par value, 6% preferred stock, callable at $105 plus all unpaid dividends, in addition to the 7% preferred and common then outstanding. Dividends on the new 6% preferred were to be cumulative and prior to common. Sinking fund requirements were to be an amount equal to 10% net income after certain deductions. (R. 167a.) The plan, which was optional to the holders of the outstanding 7% preferred stock, offered (R. 168a)—

> to each holder of said stock the right to exchange each share of his seven per cent preferred stock of the Company for one share and 15/100ths of a share of the Company's new six per cent preferred stock, plus an extra dividend on each share of his seven per cent stock of one-tenth of a share of the Company's new six per cent preferred stock and in connection with such exchange, to receive in payment of all arrears of dividends up to and including the quarterly dividend period ending September 1, 1936, on each share of the seven per cent preferred stock exchanged as aforesaid, a stock dividend of three-tenths (3/10ths) of a share of new six per cent stock of the Company at par.

All the shares of the 7% stock so exchanged were to be retired and canceled. Toward the end of 1936, the plan became operative upon the acceptance of its terms and exchange by holders of 6,824

shares of the 7% preferred stock out of a total of 6,952 outstanding shares. (R. 168a.) The remaining small amount of outstanding 7% stock was retired, part in 1936 and part in 1937, by payment of accumulated dividends in cash and redemption at the call price of $115 a share (R. 169a). Dividend and sinking fund requirements for the 6% stock were met by taxpayer for 1937 (R. 169a–170a).

The Tax Court held (R. 160a–178a) that the transaction arising out of the agreement of September 24, 1936, constituted a recapitalization of the taxpayer and was therefore a reorganization within the meaning of Section 112 of the Revenue Act of 1936; that the 6% preferred stock received in payment of all arrears of dividends was received pursuant to the plan of reorganization and not as a taxable stock dividend, and that, under Section 27 (h) of the Revenue Act of 1936, the taxpayer was not entitled to a dividends paid credit. The circuit court of appeals affirmed (R. 181–189).

ARGUMENT

1. The decision below is clearly correct and raises no novel nor important question. Without dispute, the transaction involved a recapitalization to the extent of the exchange of the 1.15 shares of 6% preferred for each share of 7% preferred stock (R. 175a, 185). Moreover, to the extent that a recapitalization is involved, the transaction clearly falls within the statutory definition of a

nontaxable reorganization (Revenue Act of 1936, Sec. 112 (a), (b) (2) and (3), and (g) (1) (D); Appendix, *infra,* pp. 12–13), and constitutes a nontaxable distribution in the hands of stockholders with respect to which Section 27 (h) (Appendix, *infra,* p. 12) explicitly disallows a dividends paid credit. Taxpayer claims, however, the existence of a transaction separable from the recapitalization in that the .4 of a share of 6% preferred stock, included in the exchange for the 7% stock under the plan, in addition to the 1.15 shares of 6% preferred stock, constituted a stock dividend taxable under Section 115 (a), (f) and (g) (Appendix, *infra,* pp. 13–15), and hence authorized a dividends paid credit under Section 27 (a) and (e) (Appendix, *infra,* p. 12). On the contrary, the Tax Court found the fact to be (R. 177a)—

> that the consideration for the exchange of each share of 7 per cent stock was the receipt of 1.55 shares of 6 per cent stock and that it can not be separated into two or more independent steps.

In the absence of controlling statute or regulations, whether the transaction is to be regarded as entire or severable was correctly held by the court below to constitute a factual issue directly ruled by the *Dobson* case [2] to be a matter within the province of the Tax Court (R. 185). The record and, in particular, the terms of the re-

[2] *Dobson* v. *Commissioner*, 320 U. S. 489, 502, rehearing denied, 321 U. S. 231.

organization plan in the light of taxpayer's financial situation, afford ample support for the factual conclusion of an integrated rather than a severable transaction, which the Tax Court reached (R. 177a, 185–186). Thus, though purportedly the plan paid a dividend on the 7% stock (R. 168a), a 7% stockholder received no "stock dividend" unless he accepted the plan; he could not retain his 7% stock and receive the "dividend" (R. 177a, 186). Furthermore, the circumstances which evoked the plan are consistent with a single and not a separate character: Extrication of taxpayer from its financial predicament due to heavy past obligation and future commitment for dividends and sinking fund payments plus short cash position. The inference is reasonable that all of the 6% stock was distributed in exchange and in compensation for the surrender of rights in 7% stock. The result below is further confirmed by the similar conclusions reached in other cases based upon analogous factual situations. *Skenandoa Rayon Corp.* v. *Commissioner,* 122 F. 2d 268 (C. C. A. 2d), certiorari denied, 314 U. S. 696; *Morainville* v. *Commissioner,* 135 F. 2d 201 (C. C. A. 6th); *Knapp-Monarch Co.* v. *Commissioner,* 139 F. 2d 863 (C. C. A. 8th).

Taxpayer's argument (Pet. 7–10) fails to recognize that Sections 112 and 115 are contained in the same statute and are to be interpreted consistently. Thus, the statute contemplates that a *bona fide* reorganization, falling within the non-

recognition provisions of Section 112 (compare *Gregory* v. *Helvering,* 293 U. S. 465), constitutes an exception, among others, to the terms of Section 115 (a), (f) and (g), dealing with stock dividend distributions. This appears plainly in the language of Section 115 (h) (Appendix, *infra,* p. 15), which, so far as pertinent, reads:

> The distribution * * * to a distributee by or on behalf of a corporation of its stock * * * shall not be considered a distribution of earnings or profits of any corporation—
>
> (1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, * * *.

Once the transaction is, as here, found as a matter of fact to be entire and not severable, Section 112 forestalls recognition of gain or loss from any part of the exchange of securities included in the reorganization which are issued by a corporate party to it; stock distributions incident thereto are for that reason nontaxable and no issue can arise, such as taxpayer seeks here to assert (Pet. 9, 11), as to whether or not the stock distribution alters the proportionate interest of the stockholders.

2. There is no inconsistency between the decision of the court below in the instant case and its decisions in *Bazley* v. *Commissioner,* 155 F. 2d 237, petition for certiorari pending, No. 287, this Term, and *Adams* v. *Commissioner,* 155 F. 2d 246, petition for certiorari pending, No. 209,

this Term.[3] In the cited cases, the court below held that Congress, in Section 112, did not intend to exempt all "reorganizations" from tax consequences, but only those which are required by corporate business exigencies or undertaken for reasons germane to the continuance of the business of a corporation, a party to the reorganization.[4] Consistently with this holding, the court below, contrary to the assertion made by the taxpayer in its petition (pp. 4–5, 10), applied to the instant record the legal standard enunciated in the cited cases, and referring to the *Bazley* case, expressly ruled that the facts found by the Tax Court show a statement of *corporate* purpose (R. 181–183). The findings of the Tax Court that taxpayer's certificate of incorporation was amended to permit the adoption of the reorganization plan whereby arrears on preferred stock would be eliminated (R. 167a) and the sinking fund provisions made less stringent (R. 174a), and its additional findings that taxpayer was feeling the effects of the depression (R. 164a) and was in a short cash position (R. 167a), clearly support the holding of the court below. Since the reorganization here, unlike the factual situations in the *Bazley* and *Adams* cases, possesses clear business purpose ger-

[3] These decisions were rendered by a divided court on April 16, 1946, two days previous to the decision here (R. 190).

[4] *Bazley* v. *Commissioner*, *supra*, pp. 242–244; *Adams* v. *Commissioner*, *supra*, p. 247. Compare Treasury Regulations 94, promulgated under the Revenue Act of 1936, Art. 112 (g)–1 and Art. 112 (g)–2.

mane to corporate continuance, the additional circumstance that the plan may also have served business interests personal to taxpayers' stockholders is surplusage. Thus the issue involved in the cited cases, upon which the court below divided,[5] is not here present.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.

SEWALL KEY,
Acting Assistant Attorney General.

ROBERT N. ANDERSON,

I. HENRY KUTZ,
Special Assistants to the Attorney General.

OCTOBER 1946.

[5] Indeed, two of the three judges joining in the instant decision dissented in the *Bazley* and *Adams* cases, in which five judges sat.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit In General.*—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * * * * *

(e) *Taxable Stock Dividends.*—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

* * * * * * *

(g) *Preferential Dividends.*—No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.

(h) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of

the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely In Kind.*—

* * * * *

(2) *Stock For Stock Of Same Corporation.*—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) *Stock For Stock On Reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of a plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(g) *Definition of Reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means * * * (D) a recapitalization, * * *.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definitions Of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without

regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(f) *Stock Dividends.*—

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) *Election of Shareholders as to Medium of Payment.*—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumu-

lated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

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